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E.O. 12958: DECL: 09/28/2016
TAGS: ECON PGOV ETRD EFIN EINV CH
SUBJECT: REASONS BEHIND THE LIMITED RESPONSE TO FEVERISH INVESTMENT

REF: BEIJING 17937

Classified By: Charge d'Affaires, a.i., David S. Sedney. Reasons 1.4 (b/d).

SUMMARY

¶1. (C) SUMMARY: Several contacts have pointed out reasons they believe that China will not or should not pursue bold action in the near term to deal with high rates of investment and credit growth. A private sector economist emphasized Premier Wen Jiabao's desire for officials -- including regulators with narrowly defined charters --to reach "consensus" on major economic issues, a process that slows down decision making. A researcher who advises the government said that significant renminbi appreciation is not an attractive option for economic policy makers focused on job creation, the growing rich-poor divide, and overall social stability. A government macroeconomist downplayed the idea of "overheating" and asserted that the 30 percent growth rate in fixed asset investment (FAI) can be checked with administrative measures alone. An academic observed that many local officials are still evaluated against growth rates, making it difficult to restrain investment supported by local governments. END SUMMARY.

LOTS OF MONEY SLOSHING AROUND...

¶2. (C) FAI continues to grow at a feverish pace: 30.5 percent in the first sixth months of this year compared to 2005. Among the sources of funds for all this investment are large inflows from abroad, including: China's global trade surplus, which was over USD 14 billion per month in June and July; "hot money" associated with speculation on the renminbi, impossible to accurately quantify but very roughly estimated by the National Bureau of Statistics to have averaged nearly USD 6 billion per month between February and May; foreign direct investment, which so far this year has averaged above USD 4 billion per month; and increasing profits for many firms, up 29 percent so far this year among major industrial enterprises.

¶3. (C) With capital controls limiting outward investment, accumulating funds are often either lent out by banks or

spent by corporations on new industrial capacity or residential construction. This spending is in addition to large government projects already under way, including housing projects, facilities for the 2008 Olympics, and the expansion of transportation infrastructure in the form of ports, airports, railways, and highways. Concern among government and private sector economists about overcapacities in industries like steel and cement results in part from the enlargement of these sectors in response to government-funded infrastructure expansion.

SLOWDOWN COMING TOO SLOWLY?

¶4. (C) Citibank's Vice President for Asia/Pacific Research, Shen Minggao, who recently jumped to the firm from a research position at Beijing University, is concerned that recent efforts to slow down FAI growth are too little too late. Shen lamented that two interest rate hikes this summer and a slew of administrative measures aimed at slowing the buildup of overcapacity in construction-related sectors are far too limited. Over the coming years, the consequence of the slow government response is likely to be deflation in some sectors and an overall surge in non-performing loans, said Shen.

¶5. (C) Shen also raised concerns that China is moving too slowly to use its most effective tool: currency flexibility. He and numerous other economists believe that were the renminbi allowed to appreciate significantly, funds inflows that fuel investment growth would slow measurably -- first as a result of speculation drying up, followed by an eventual decline in the trade surplus resulting from cheaper imports and a fall-off in exports in price-sensitive sectors such as apparel and lower-end electronics. He added that given

prospects of weaker U.S. demand, the window may be closing on the ability to allow greater renminbi appreciation. Further, because efforts to tighten investment will most often impact industries geared to production for internal consumption, one result would be a fall off in imports, exacerbating China's global trade surplus.

GOVERNANCE CHALLENGES

¶6. (C) Shen further described to us a lowest common denominator approach to key economic decisions under the direction of Premier Wen Jiabao. In Shen's view, Wen will only provide clear and decisive direction on two issues: maintaining grain production targets and controlling inflation. Everything else is held hostage to a lengthy process of different government players -- including regulators with narrowly defined charters -- pressing their parochial agendas until "consensus" is reached, he said.

¶7. (C) China Academy of Social Sciences (CASS) Senior Research Fellow Dr. Wang Tongshan said that although the Eleventh Five-Year Plan aims to inject balance into the economy, China is actually moving away from such a goal, with fixed asset investment presently rising at twice the rate of consumer spending. Further, economic policy makers are very focused on job creation, the growing rich-poor divide, and overall social stability, so they are reluctant to allow for appreciation of the renminbi. The best course, in his view, is stronger administrative controls on credit and restrictions on land use.

NDRC: NEED CONTROL BUT EXISTING APPROACH SUFFICIENT
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¶8. (C) Dr. Wang Xiaoguang, who directs the Macroeconomics Division at the National Development Reform Commission (NDRC) Institute of Economic Research echoed our CASS contact concerning the need for administrative controls related to projects, capital, and land. He went a step further in

expressing confidence in such measures, asserting that recent moves to slow or halt new projects will be sufficient to arrest spiraling FAI growth rates. Wang predicted that in six months, the FAI growth rate will fall five percentage points to 25 percent (comment: this is still a very high rate of increase). He said there would soon be more focus by the government on issues such as project quality and environmental impact. Like CASS's Dr. Wang, NDRC's Dr. Wang ruled out using renminbi appreciation as a tool for macroeconomic cooling.

THE CHALLENGE FROM LOCAL GOVERNMENTS

¶9. (C) Hu Angang, Director of the Center for China Study at Tsinghua University's School of Public Policy and Management,

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said that the Chinese government has for years emphasized rapid economic growth, and local governments still have many incentives to seek higher GDP figures. With many local officials actually evaluated against growth rates and some looking ahead to next year's Party Congress, it is naturally difficult to restrain local government investment. Hu explained that the issue is further complicated by local authorities having a large say in the loan decisions of local bank branches. When projects fail, it is the bank, whose local branch had lent the money under local government pressure, which must clean up the loan, and local officials involved at the inception may be long gone.

¶10. (C) Beijing has recently become more forceful in its efforts to control investment at the provincial level and recently went so far as to publicly reprimand officials in Inner Mongolia for pursuing unauthorized power projects. The Central Government separately announced in early August that it would dispatch economic inspection teams to key provinces to compel them to more closely follow Beijing's direction. Local officials in Inner Mongolia as well as Hunan appeared dismissive when discussing the Central Government's push with us (further details in reftel).

DOUBTS ABOUT INTEREST RATES

¶11. (C) Beijing University Center for Economic Research Director Lin Yifu told us that with China's economy still in transition, monetary policy is less effective as a tool than administrative controls. He emphasized the problem of growing overcapacity, but noted that most investment comes from retained earnings, so investors are ultimately insensitive to interest rate changes. Many people believe returns of 20 percent are available in sectors like real estate, and this makes a 2.25 percent interest rate for deposits pale by comparison. Even deposit rates of 5 percent -- more than double current rates, make no difference, in Lin's view.
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